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PAST, PRESENT, AND FUTURE

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We live in the present with an eye to the future, but with the present and future deeply rooted in the past. In looking backward, a stance is given for looking forward and I propose, first of all, to look back over the years since 1920 that I have been identified with the banking profession. In analyzing and comparing some of the events that have taken place during that time, perhaps some new light can be thrown on the relationship of our supervisory duties to the operations of the banks for which the public holds us responsible.

As an aftermath to World War I, the inflationary bubble of the war years burst in 1920. Commodity prices fell drastically with pronounced adverse repercussions on the commercial banking system. Loans and investments that had been made on inflated wartime values defaulted and brought about numerous bank failures. The agricultural sections of the nation were particularly hard hit and experienced severe depression beginning in that year. Meanwhile, a resurgence of pent-up wartime demands brought prosperity to the areas of the country in which commerce and industry were concentrated. This was the time of the so-called "new era" when a false sense of financial security was encouraged by a pseudo price stability. The fact was ignored that an even price level had been produced by an averaging of rising finished goods prices and falling agricultural prices. Overconfidence in the economic future fanned the embers of speculation into flame and a major inflation of security prices occurred that swept on to a climax and collapse in 1929.

The ending of the speculative boom pulled the props out from under the values of the assets supporting the commercial banking system and heralded the onset of the depression years of the 1930's. A new and cataclysmic wave of bank failures followed the spread of economic distress from agriculture into commerce and industry. Between 1929 and 1933 the number of commercial banks fell from 24,970 to 14,207. Emergency fiscal and monetary measures taken during later depression years were able to stimulate a substantial increase in commercial bank deposits from a low point in 1933, but in the absence of restored business confidence bank loans did not rise and values remained in the doldrums.

It was learned from this experience that emergency measures aimed at increasing the volume of bank deposits by pump-priming processes cannot by themselves repair values that have been destroyed by deflationary forces stemming from a previous inflation, or fully restore public confidence in a shaken banking system. Alive to these circumstances, public attention was focused on what methods could be devised to maintain confidence in the safety of the banks for all time and prevent them from again falling prey to the evils of a cumulative loss in values generated in part by actions they themselves had been forced into in order to defend their solvency.

Remedial legislation evolved out of ensuing studies and Congressional debates. As a buttress against the depressive effects on values that occurred in bad times when banks were obliged to meet deposit losses by forcing the liquidation of loans, the Federal Reserve Act was amended to strengthen its primary purpose of providing an elastic currency by way of augmenting the availability of loan credit to the commercial banks. This was done so that heavy and unforeseen withdrawals of deposits could be met by borrowing at the Federal Reserve Banks rather than by forcing the liquidation of loans and investments to meet that contingency. In thus having devised a practicable method for helping to conserve the asset values of a single bank from unforeseen deposit pressures, a means had also been provided for preventing the cumulative spread of such pressures to other banks.

An answer to the problem of how to maintain confidence in the banking system in good times and in bad was next found in the creation of the Federal Deposit Insurance Corporation. Between deposit insurance and the ready accessibility of emergency Federal

Reserve Bank credit, there is no doubt that the banking system has been immeasurably strengthened against the kinds of vicissitudes that have been described and by which it has been sporadically plagued in the past.

So much for history. The question remains whether a banking system, relieved from the prospect of the kinds of difficulties by which it has formerly been beset, is fully poised to contribute its strength constructively to an economy dependent on stability and growth for its long-run utility. The bank supervisory agencies enjoy their widest opportunities in this area for rendering economic and social public service.

Broadly speaking, it is the responsibility of the bank supervisory agencies to determine by examination that the assets of the banks subject to their authorities are adequate in quality to assure the protection of depositors and that capital funds exist in sufficient amount to supply an overlaying margin of safety. A measurement of these two factors reverts to the human equation, and bank supervisory authorities must also be satisfied that bank managements have the capacity to perform their duties in accordance with established standards of proficiency and integrity.

In the performance of their duties, bank supervisors must consider both the positions of the individual banks and the composite position of all of the banks for whom they are responsible. As time passes, it is becoming constantly more evident that the composite position of all banks -- namely, the banking structure -- must become the sharpest focus of bank supervisory attention.

The record of banking legislation since 1920 has been to shore up the structural banking weaknesses that adversity had exposed in stark and somber reality. Trust in the knowledge that the recurrence of earlier kinds of banking difficulties has been guarded against legislatively may very largely account for the present willingness of bankers to engage in credit practices that would have been questioned in years gone by. Given an acceptable quality of loans and investments, banks now enjoy the mechanical facilities for meeting their deposit obligations under all conceivable circumstances. Today's unanswered question is whether the composition of bank loans and investments contributes to national growth and stability to the greatest extent possible. Bankers and bank supervisors alike share responsibility for finding the correct answer and, in so doing, to eliminate any errors of omission or commission that are harbored in existing banking practices.

In order to point up the question, it is advisable to look back into the past and to review some of the changes in banking practices that have taken place and their effects on the banking structure. Take the key provisions of the real estate loan authority of national banks as a first example: In 1926, Congress broadened the powers of national banks to make loans upon first mortgages on city property by increasing from one to five years the maximum maturity allowable and by setting one-half of their savings deposits, or 25 per cent of the amount of their capital stock and surplus, as might be elected, for the permissible ceiling amount of such loans that could be carried. No loan might be made in excess of 50 per cent of the actual value of the real estate offered for security. The purpose of this legislation was to improve the competitive position of national banks in relation to State banks who, as a class, were operating under broader lending powers in the real estate mortgage field.

Thirty years later finds national banks authorized to make real estate loans secured by first liens upon improved real estate, including improved farm land and improved business and residential properties, up to 66-2/3 per cent of the appraised value of the real estate offered as security, and for terms up to ten years when secured by an amortized mortgage, the instalment payments on which are sufficient to amortize 40 per cent of the principal of the loan within that period; and up to twenty years if the instalment payments on the loan are sufficient fully to amortize its principal within such maturity. Furthermore, real estate loans insured under the provisions of the National Housing Act are exempted entirely from these liberalized limitations; and the total permissible amount of real estate loans that can be carried has been set at 100 per cent of the capital and surplus of the lending bank, or 60 per cent of the amount of its time and savings deposits, whichever is the greater. The Congress in its past session saw fit to broaden the real estate lending power of national banks still further by, among other liberalizing measures, raising from 66-2/3 per cent to 75 per cent the percentage of appraised value of real estate that may be taken as security to loans amortizable within a period of 20 years.

The reference made to the vastly expanded real estate mortgage lending authority that has been granted to State and national banks over the years is not to dispute the economic usefulness of these broader lending privileges or the push that as a result has been given to the socially desirable objective of increasing home ownership. My purpose has been to dramatize an evolution in commercial banking practice that has moved away from a time established liquidity principle -- that essentially demand liabilities should be balanced by an appropriate arrangement of short-term assets -- to a revised concept that has widened the eligibility of longer term assets for inclusion in commercial bank loan portfolios on the grounds that the factors of amortization and the ready accessibility of emergency Federal Reserve Bank credit remove the objections that hitherto had existed to this practice.

Similar reasoning has been used to justify the widening commercial bank policy of making term loans whose payment through instalments is geared to the projected cash flows and earning power of the borrower. There is not the slightest doubt that term loans have filled an important gap in the list of commercial bank lending services and that they have been an important element in the array of credit and capital devices that have done so much to raise the American standard of living and to establish our country's stature as a world power. Notwithstanding the desirable attributes of term loans, their existence in large volume in commercial bank loan portfolios is subject to the same reservations that have been made regarding current real estate mortgage loan practices; namely, that the effect of carrying substantial amounts of long-term paper tends to reduce what should be a bank's built-in liquidity and thereby to increase its reliance on extraneous factors, such as emergency Federal Reserve Bank credit, to insure satisfaction of its deposit liabilities. Furthermore and regardless of the quality of a bank's long-term paper, the fact remains that as the percentage of such paper to the total of all paper carried rises, its ultimate capacity to fulfill its short-term community lending duties may come to be correspondingly constricted. It is in the dynamic field of short-term lending that banks have historically performed their most important credit service in catering to the temporary working capital needs of their communities. Any structural change in bank lending practices that might eventually interfere with this function must be a matter for concern, and especially so if it should be made under the guise of some untested concept of what constitutes adequate bank liquidity.

When examining the evolution of commercial bank longer-term lending practices, developments in the field of consumer instalment credit give most pause for thought. Where commercial banks are now the most important of all direct and indirect purveyors of consumer instalment credit, and where consumer instalment debt has become a critical factor in the aggregate of all types of obligations outstanding, its place within the context of the forms of obligations held by commercial banks demands intensive and continuous study. Again, as in the case of real estate mortgage loans and term loans, there is indisputable evidence that commercial bank participation in the field of consumer instalment credit has added a plus factor to the improvement of living standards and the comfort and convenience of countless people from one end of the country to the other. Nevertheless, the steady increase in the proportion of consumer instalment paper to the total of all paper carried by commercial banks raises the question whether this trend in commercial bank lending policies is being undertaken at the expense of reduced banking liquidity and the ultimate ability of banks to function along historically accepted lines of proven public value. Moreover, a type of credit transaction that permits possession of desired goods or services on the basis of a narrow initial equity at some point may reveal by hindsight that a consequence has been to weaken the will of borrowers to respect the terms of the obligations which they have assumed. The tendency for commercial banks and important outlets of retail distribution to offer new variations in the forms of consumer credit, such as revolving credit, that are attractive to the buying public is another force adding to the total of consumer credit held by commercial banks and complicating a clear-cut analysis of where these developments may eventually lead.

In all events, careful thought must be given to the implications for commercial bank liquidity and ultimate capacity for public service in the swelling total of long-term paper that is held by the commercial banking system. Is there any possibility that a sort of hardening of the arteries will afflict the commercial banking system and act to slow down the circulatory economic benefits that are intrinsic to a concentration of banking energies on financing the short-term working capital needs of commerce and industry? To be sure, a Federal Reserve System monetary and credit policy that acknowledges economic stability and growth as its objective contemplates increases in bank deposits and money supply that are consistent with rising national productivity and growth. However, if a secular expansion of bank deposits promoted by Federal Reserve System action is constantly counterbalanced by additional commercial bank holdings of long-term paper, presumably bank capacity to service the working capital needs of commerce and industry at some point may be impinged upon.

In a somewhat remote illustration, I vividly recall the banking situation in my own State of Oregon in 1920 at the time of my initiation into the banking profession. The impact of the post-World War I drop in commodity prices within the space of one year had forced a major Statewide contraction of deposits that necessitated an equally rapid increase in commercial bank borrowings in order to bridge the gap to lowered deposit totals. I can recall the cases of many banks whose borrowings were in excess of their deposits. In result, their ability fully to perform their normal community credit service functions, was cut off for a considerable time. Although the safeguards embodied in the current types of instalment obligations, and in the emergency facilities available for Federal Reserve Bank credit, stand to prevent anything like this kind of unfortunate situation, even so, a gradual atrophy of commercial bank lending flexibility cannot, in my opinion, be ruled out of thought if trends in long-term lending should continue indefinitely on their present course. Federal Reserve System monetary and credit policy actions to expand the money supply can go a long way toward alleviating any future problems of this kind by constantly adding a top layer of liquidity to commercial bank positions, but whether it is possible to do so without provoking inflationary consequences raises still another question.

Everything considered, the problem remains as to how far the commercial banking system can properly go in increasing its holdings of long-term obligations without running the risk of impairing its general liquidity and ultimate capacity for well-rounded public service. All of the conjectures that have been cited regarding credit developments in the commercial banking field lead to the inescapable conclusion that to the fullest extent possible personal and business transactions conducted through the use of accumulated savings are preferable to those financed through the use of credit if the latter transactions should not, as a whole, be conducive to the maintenance of a liquid and viable commercial banking system.

Evolutionary changes in the structural make-up of the commercial banking system have proceeded part and parcel with the credit developments that have been discussed. As against 30,291 commercial banks operating in 1920, that number had been reduced by 1958 to 13,540. However, by virtue of branches, mergers and consolidations, the total number of banking outlets serving the public in 1958 stood at 22,608. An earlier overbanked situation was corrected in the years between 1920 and 1958, but considering population growth, and especially taking account of the broader range of banking services that are sought after by the public, the number of banking offices now operating is none too ample.

Aside from any question about the present structural adequacy of the commercial banking system, the physical change that it has undergone -- which has seen a reduction in the number of individual banks paralleled by a rise in the number of banking offices and an increase in the size of operating commercial banks -- poses problems to be resolved in the future. Have these changes been to the advantage of maintaining a vigorous dual banking system? To what extent are objections to bank mergers and consolidations offset by the factors of economy and efficiency that often are cited as compelling arguments favoring the ability of larger banking units to meet the mass banking needs of a rapidly growing population? Will a time come demanding some arbitrary choice between the presumed advantages of large scale bank operation and the possible dangers that the resulting concentration of banking resources can lead to an undesirable lessening of competition and to monopoly practices?

These are all problems that we who are vested with bank supervisory responsibilities must approach with a philosophical detachment requiring an analysis of the commercial banking system as a whole as well as an analysis of its component parts. In the pursuance of that aim it is incumbent on us all to take a fresh look at the trend of commercial bank credit developments and decide whether or not they are consistent with the kind of economically constructive banking system for which we are held accountable.